

ANALYSIS OF ORIGINAL BILL

Franchise Tax Board

Author: Ackerman Analyst: Roger Lackey Bill Number: AB 197
Related Bills: None Telephone: 845-3627 Introduced Date: 01-21-99
Attorney: Doug Bramhall Sponsor: State Bar Association

SUBJECT: Limited Partnerships & Limited Liability Company Conversion

SUMMARY

This bill would authorize California general partnerships to convert to California limited liability companies (LLCs) or California limited partnerships (LPs) and would authorize California LLCs and LPs to convert to general partnerships and foreign and other business entities.

This analysis will only address those provisions that impact the department.

EFFECTIVE DATE

This bill would be effective January 1, 2000.

Program/Background

In 1996, legislation revised the statutory scheme governing the formation, operation and dissolution of general partnerships, in accordance with the Revised Uniform Partnership Act ("RUPA") (AB 583 [Sher], Ch. 1003, Stats. 1996). RUPA permits a general partnership to convert into a California or foreign LP, a California or foreign LLC, or a foreign unincorporated association. This Act also permits LPs or LLCs to convert into a California general partnership, but these provisions currently are not effective because the statutes governing California's LPs and LLCs do not expressly permit such a conversion.

SPECIFIC FINDINGS

Existing state law authorizes the creation of an LLC and the registration of LLCs created under the laws of other states. The tax treatment of an LLC under existing state law depends on its classification for tax purposes.

In general, if an LLC has more than one owner (known as "member"), it is classified as a partnership for federal and state tax purposes unless it elects to be classified as a corporation. If an LLC has a single member, its existence as an entity separate from its owner will be disregarded for federal and state tax purposes unless it elects to be classified as a corporation.

Under **existing state law**, an LLC classified as a corporation for federal and state tax purposes is subject to the corporation franchise tax, including the minimum franchise tax, or the corporation income tax like any other corporation.

Board Position:

<u> </u> S	<u> </u> NA	<u> </u> NP
<u> </u> SA	<u> </u> O	<u> </u> NAR
<u> </u> N	<u> </u> OUA	<u> X </u> PENDING

Department Director

Date

Gerald Goldberg

3/24/1999

As a result, an LLC classified as a corporation that is organized in this state or registered with the SoS is required to prepay the corporate minimum franchise tax to the SoS at the time of organization or registration.

In addition to corporation income tax and franchise tax, **existing state law** provides that every LP and LLC not classified as a corporation (i.e., classified as a partnership or disregarded) that is organized in this state, registered in this state, or doing business in this state shall be subject to an annual tax in an amount equal to the minimum franchise tax until the effective date of cancellation or, if later, the date the entity ceases to do business within the state.

Existing state law provides that an LLC not classified as a corporation shall also pay an annual fee based on the total income from all sources reportable to this state for the taxable year. For example, an LLC with total income for the taxable year greater than \$250,000, but less than \$500,000, the fee would be equal to \$500. As the total income for the year increases, so does the fee to a maximum amount of \$4,500 based on a total income that exceeds \$5 million. The annual fee payable by LLCs is required to be adjusted annually for taxable years beginning on or after January 1, 1999. Limited partnerships do not incur a fee.

In addition, **existing state law** provides that prior to the cancellation of any LLC, the LLC must obtain a tax clearance certificate from the Franchise Tax Board (FTB) certifying that the taxes and fees due, if any, for the LLC entity have been paid, assumed or guaranteed by bond or otherwise.

The FTB either issues the tax clearance certificate or notifies the requesting entity of the amount of tax that must be paid or the amount of bond, deposit, or other security that must be furnished as a condition of issuing the certificate. The FTB notifies the Secretary of State (SOS) when all taxes have been paid or secured. As of that date, the SOS files the certificate of cancellation, dissolution, or withdrawal. As of the effective date of the cancellation or withdrawal, the LLC is no longer subject to the annual tax and fee or the minimum franchise tax, as the case may be, for taxable or income years beginning on or after that date, unless the LLC conducted business in this state.

Also, **existing state law** provides certain provisions for the merger of corporations. Upon gaining the approval for a merger, the merging corporations must file an agreement of merger with the SOS. However, the SOS may not file the agreement of merger, until a certificate of satisfaction from the Franchise Tax Board has been filed providing that all taxes imposed on the corporation terminating as a result of the merger have been paid or secured.

Currently, upon the merger or conversion of a corporation with another entity, the two entities for tax purposes are treated distinct and the disappearing entity's tax year is considered to have ended on the effective date of the merger or conversion. However, the assets, debt, and liabilities (including taxes owed by the merged corporation) etc. pass on to the remaining entity.

This bill would make the RUPA provisions allowing general partnerships to convert into a LLC or LP effective by making the necessary amendments in the statutes governing LLCs and LPs.

This bill also would provide specific guidelines for the conversion of LPs and LLCs into another business entity or a foreign limited partnership.

This bill would provide that the filing with the SOS of a certificate of conversion or a statement of partnership authority or articles of organization containing a statement of conversion would have the same effect of the filing of a certificate of cancellation by the converting entity, and that the converting entity would not be required to file a certificate of dissolution or cancellation as a result.

This bill would provide that an entity that converts into another entity is for all purposes the same entity that existed before the conversion, including all rights and property, and liability for all debts, liabilities, and obligations of the converting entity.

This bill would make additional miscellaneous and technical amendments that would not impact the department.

Policy Considerations

By providing that the filing of a certificate of conversion or other specified statement shall have the effect of the filing of a certificate of cancellation for a converting entity, without the additional explicit requirement for a tax clearance or certificate of satisfaction, this bill would appear to permit an entity to cancel or withdraw (via conversion) without obtaining a tax clearance certificate. Therefore, the converting entity would not have to resolve its tax debt before cancellation or withdrawal, as required by current law.

State law provides specific schemes regarding the tax treatment of LPs and LLCs on the basis of the classification of the entity for tax purposes. Each scheme provides specific rights or obligations that allow each type of business entity to be unique. This bill provides after an LLC converts into an LP, it would still be an LLC for all purposes. Under California law, a converted LLC cannot be the same as an LP for tax purposes due to mutually exclusive statutory provisions. By deeming that a converted entity is for all purposes the same entity that existed before the conversion, this bill would be incompatible with existing law regarding the taxation of specific entities.

Implementation Considerations

This bill provides that an LLC that converts to another entity such as an LP would be for all purposes the same entity that existed before the conversion. Given the nature of the tax schemes described above, the FTB could not implement this provision without further clarifying amendments.

FISCAL IMPACT

Departmental Costs

This bill would not appear to significantly impact the department's cost once the implementation concerns are resolved.

Tax Revenue Estimate

This bill would not appear to significantly impact the state's income tax revenue.

PROPOSERS OF THE LEGISLATION

This bill is sponsored by the State Bar Association's Business Law Section.

BOARD POSITION

Pending.